

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:MWD:MIL:TL-N-LO-2484-98
JMKlein:cs:am

date: July 20, 1999

to: [REDACTED]
Team Coordinator, [REDACTED]

from: JAMES M. KLEIN
Attorney

subject: [REDACTED] Contingent Liabilities

This responds to your various requests for advice regarding the above matter. It constitutes our conclusions pertaining to the issues of whether the taxpayer, [REDACTED], may deduct certain payments for accrued contingent liabilities it assumed as part of a reorganization.

FACTS AND ANALYSIS

In [REDACTED], [REDACTED] formed a new corporation known as [REDACTED] ("Newco"). As part of a plan to make an initial public offering of stock in "Newco", [REDACTED] reorganized [REDACTED] ("Target") and its related subsidiaries into one business and transferred the business and assets of Target to Newco, pursuant to a reorganization agreement dated [REDACTED].

The reorganization agreement provides that Newco will assume all [REDACTED] liabilities, other than the retained liabilities, as part of the consideration for the Newco assets. Included in the [REDACTED] liabilities was \$ [REDACTED] of contingent liabilities. During the years under examination, [REDACTED] and [REDACTED], certain of these contingent liabilities became fixed and determinable and were deducted by Newco as expenses, rather than amortized.

Since the reorganization merely resulted in a change in the composition of Target's capital structure and not a change in control, it was not treated as a sale for financial reporting purposes. For book purposes, the historical cost basis of Target's assets and liabilities were carried over to Newco without adjustment. Included in the historical cost carryover were the reserves for contingent liabilities which were booked

for GAAP purposes by Target but not yet recognized for tax purposes.

Examination adjustments pertaining to the reorganization were made to the [REDACTED] federal corporate income tax return of [REDACTED]. The Fair Market Value of the inventory acquired by Newco was reduced by \$[REDACTED]. Additionally, \$[REDACTED] of sales allowances and volume discounts and contingent liabilities assumed and expensed by Newco, were capitalized.

You have requested an opinion on the proper tax treatment for [REDACTED] of the contingent liabilities assumed by Newco at the time that they become fixed and determinable. The following are the facts specific to each of these [REDACTED] contingent liabilities.

Postretirement Benefits and Postemployment Benefits

Pursuant to the reorganization agreement, Newco assumed \$[REDACTED] of postretirement benefits accrued on Target's books under the provisions of FASB No. 106, "Employers' Accounting for Postretirement Benefits other than Pensions". These liabilities are primarily post retirement health and life insurance benefit obligations for future retirees. Target retained the accumulated postretirement health and life insurance benefit obligations relating to all U.S. employees who retired on or before July 1, 1994. Newco capitalized \$[REDACTED] of this liability.

Similarly, Newco assumed a \$[REDACTED] reserve for postemployment benefits and a \$[REDACTED] current reserve for postemployment benefits accrued on Target's books under the provisions of FASB No. 112, "Employers' Accounting for Postemployment Benefits", which requires employers to recognize the cost of benefits provided to former or inactive employees after employment but before retirement when it is probable that a benefit will be provided. Such benefits include worker's compensation, disability and continuation of health care benefits. Exhibit A to the reorganization agreement states, "Newco shall assume and thereafter pay, perform and discharge and all employment, compensation and benefit liabilities, whether arising prior to or after the Closing Date, with respect to those employees who, as of the Closing Date, are on leave of absence, long-term disability, short-term disability or layoff with recall rights and the dependents of those persons." The exhibit contains a listing of [REDACTED] former salaried employees who are on long-term disability.

Warranty Reserve

Newco assumed \$ [REDACTED] of accrued warranty reserve. Of this total, Newco capitalized \$ [REDACTED], which represents the warranty claims in process at the time of the reorganization.

Parts return Reserve

Newco assumed \$ [REDACTED] of parts return reserve, which Target maintained in accordance with FASB 348. The reserve consists of \$ [REDACTED] - an approximation, based on historical data, of the parts purchased that may be returned by pre-existing dealers; \$ [REDACTED] - an approximation of parts purchased that may be returned from potentially new dealer; \$ [REDACTED] - an approximation of parts purchased that may be returned by Target-owned dealerships that are transferred to unrelated parties; \$ [REDACTED] - an approximation of new model parts purchased which may be returned by dealers. Of the total, Newco capitalized \$ [REDACTED] representing an estimate of unprocessed parts returns.

[REDACTED] "Newco" was formerly owned and operated by [REDACTED], after it obtained the corporation in an acquisition. On [REDACTED], the reorganization occurred and Newco was formed to operate the [REDACTED] business of [REDACTED], formerly operated by [REDACTED]. [REDACTED] no longer desired to maintain the operation under its corporate structure.

The restructuring of the corporate organization of [REDACTED] was complex. A private letter ruling was obtained for this restructuring which is referred to as a "busted" IRC § 351 transaction. The transaction is considered busted because [REDACTED] had a prearranged plan to dispose of more than [REDACTED] % of the equity of [REDACTED] and therefore, the transaction failed to meet the control requirements IRC § 351 and § 368.

The parties to the restructuring transaction, [REDACTED] and [REDACTED] treated the matter as one in which Newco was treated as purchasing its assets from old [REDACTED], which had been part of the [REDACTED] affiliated group. As a result there was an allocation of the assets and liabilities subject to the purchase by Newco. This allocation has been reviewed and agreed upon by the Internal Revenue Service in connection with the examination of the prior corporate income tax returns (Form 1120) of [REDACTED]. As part of reporting the transaction Newco allocated certain amounts to reserves and estimates for potential contingent liabilities of the old [REDACTED] corporation concerning amounts to be paid by Newco.

According to the lawyers for Newco the transfer of assets was not a "sale" in the typical sense. They said ... "the reorganization resulted in substantially all of the business of Old [REDACTED] being transferred to New [REDACTED] Newco with the same ultimate shareholder, net assets, personnel, suppliers and customers, etc. The reorganization was essentially transparent to the business, except to the extent of the change it caused in [REDACTED]'s capital structure. The new capital structure of [REDACTED], after the reorganization, included the consideration provided to Old [REDACTED] for the transfer of Old [REDACTED]'s net assets to New [REDACTED] (herein Newco).

The consideration for the net assets acquired was comprised of approximately [REDACTED] New [REDACTED] common shares, [REDACTED] of Series A cumulative convertible preferred New [REDACTED] shares and \$[REDACTED] of subordinated debt. Since the reorganization merely resulted in a change in the composition of Old [REDACTED]'s capital structure and not a change in control, it was not treated as a sale for financial reporting purposes in accordance with generally accepted accounting principles ("GAAP"). As a result, the historical cost basis of Old [REDACTED]'s assets and liabilities (including reserves which were booked for GAAP purposes by Old [REDACTED] but not yet recognized for tax purposes) were carried over to New [REDACTED] without adjustment. In contrast to this historical cost approach, in a typical purchase and sale of assets, the buyer must report the acquisition of assets and assumption of liabilities under the GAAP "purchase method" of accounting for acquisitions.

The reorganization had the appearance of a carryover transaction under Section 351 of the Internal Revenue Service Code, because the net assets of Old [REDACTED] were transferred to New [REDACTED], solely in exchange for approximately [REDACTED] of New [REDACTED] common shares, [REDACTED] of New [REDACTED] Series A cumulative convertible preferred shares and \$[REDACTED] of subordinated debt. Nevertheless, as addressed by the IRS National Office in a private letter ruling, the reorganization did not qualify under Section 351 because there was a prearranged plan for [REDACTED] to dispose of more than [REDACTED]% of the equity of New [REDACTED], resulting in the failure of old [REDACTED] to meet the 80% control requirements of Section 351(a) and Section 368(c).

Despite [REDACTED]% of the common shares of New [REDACTED] remaining within [REDACTED]'s hands at the time of the reorganization, it was still necessary to assign a value to New [REDACTED] as an enterprise. Valuation was necessary both for purposes of tax reporting and to help gauge an appropriate public offering price for the shares. The valuation employed the standard methodology of discounting the estimated projected future cash flows of the [REDACTED] business.

██████ and ██████ undertook a careful review of liabilities and reserves as of the reorganization date. They determined which items properly constituted liabilities for tax purposes and consistently reflected such treatment in the determination and allocation of the purchase price for tax purposes. In this regard, ██████ and New ██████ agreed which GAAP reserves of Old ██████ were included in determining the tax basis of the transferred net assets, as well as those reserves which were not actually liabilities for tax purposes. Although these reserves were not tax liabilities, they were required to be booked by New ██████ under the carryover method GAAP rules."

The attorneys for Newco allege that the IRS respected ██████'s allocations for intangibles, but you informed us that the Service did make some changes by capitalizing \$ ██████ worth of intangibles.

With respect to this particular issue whether ██████ ("Newco") may deduct amounts allocated to the reserves for post-retirement and post-employment benefits, Newco identified the amounts as \$ ██████ for post-employment medical, \$ ██████ for post-employment medical and \$ ██████ reserved for OPEB. The reserves were maintained pursuant to FASB standards, numbers 106 and 112. Financial Accounting Standards Board, "FASB #106" applies to all types of post-retirement benefits other than pensions and is principally involved in healthcare benefits. FASB #112 applies to the estimated cost of benefits to or for inactive employees after employment, but before retirement.

As part of the reorganization contract Newco assumed various accrued contingent liabilities. Pursuant to the reorganization contract ██████ retained its liability for post-employment benefits that were already being paid to its employees on the day the reorganization occurred. Newco was to become liable for the future cost of any employee who needed post-employment retirement benefits after the date of the reorganization. Regarding these allocated reserve accounts ██████ "Newco" did not include the bases of these assets in its schedules for purposes of amortization or depreciation. It deducted the amounts during the years at issue which occurred after the reorganization. For its position regarding deductibility rather than capitalization Newco relies on the case of Buten vs. Commissioner T.C. Memo 1972-44 where the court permitted a corporation to deduct the costs for post-employment payments to the widow of a former partner of the enterprise, that later became the corporation. The government denied the deduction and argued that any provision in favor of the widow of the shareholder constituted the petitioner's cost of acquiring the assets of the partnership. The court did not

directly address the capitalization issue and the cases that support the position of the Internal Revenue Service in its opinion and allowed the deductibility of the payments for the contingent liability, based on the fact that the payments were keyed to the individual's employment with the company at the time of his death.

Notwithstanding Buten, case law and the position of the Internal Revenue Service are well settled concerning the assumption of accrued contingent liabilities regarding a business reorganization. Courts have generally held that a buyer who purchases business assets and assumes accrued contingent liabilities must capitalize payments made on the liabilities. The buyer has a basis for the amount of the liabilities which it can amortize. The principal that causes the buyer's obligation concerns the source of the buyer's obligation to pay the liability. The courts adopt an approach similar to the origin of claim doctrine, particularly delineated in Woodward vs. Commissioner, 397 US 572 (1970). Capitalization of assumed contingent liabilities is required where the source of the buyers obligation to pay the liability arose from an asset purchase. Webb Company vs. Commissioner, 77 T.C. 1143 (1981), aff'd 708 F.2d 1254 (7th Cir. 1983). See also Pacific Transport Co vs. Commissioner, 483 F.2d 209 (Cir. 1973). The court in Webb specifically referred to the case of F&D Rentals, Inc. vs. Commissioner, 365 F.2d 34 (7th Cir. 1966), cert. denied, 385 US 1004 (1967) in criticizing that court for a matter that was not before it, concluding that the court's analysis in the F&D Rentals case was pure dictum. Even if the amount of the liability is unascertainable it must be capitalized, Holdcroft Transportation v Commissioner, 153 F 2d 323 (8th Cir. 1946).

In this matter the taxpayer [REDACTED] ("Newco") assumed the contingent liabilities as part of the asset purchase and factored in a price reduction therefor. See Pierce vs. Commissioner, 326 F.2d 67 (8th Cir. 1964). We do not think the manner of paying for the business assets, that is the issuance of Newco stock, affects the reasoning supporting the government's determinations.

In addition to the foregoing Newco deducted amounts for costs pertaining to environmental cleansing of company-owned stores and amounts associated with its accrued liabilities for a parts return program for its dealers. You asked for our advice on those issues.

The foregoing discussion also pertains to these requests regarding the contingent liabilities for remediation of the environmental aspects of the company-owned stores and the contingent liabilities for the expenses for the parts return program. In fact, absent specific unusual circumstances this advice pertains to all accrued contingent liabilities of Newco resulting from the reorganization by [REDACTED].

If you have any questions please feel free to call me at
(414) 297-4239.

MARK J. MILLER
District Counsel

By: (Signed) JAMES M. KLEIN
JAMES M. KLEIN
Attorney

INFORMAL FIELD ASSISTANCE (TELEPHONE CALL)

Call Received By:

Date:

Open Date 05/26/99

Symbols:

Time:

Call Received From: James Klein

Phone: (414) 297-4239

Office: CC:MSR:MWD:MIL

District/Region: Midwest District/Midstates
Region

Taxpayer Name and TIN: [REDACTED] TL-N-LO-2484-98

Tax Years: [REDACTED]

Case In Audit

Yes ☒ No ☐

Appeals

Yes ☐ No ☒

Case In Litigation

Yes ☐ No ☒

ISP Case

Yes ☐ No ☒

Date Of Trial

CEP Taxpayer

Yes ☐ No ☒

Prior Counsel Advice:

None ☒ District ☐ Region ☐ Nat. Office ☐

Given By:

Symbols:

Phone:

Principal Code Sections: 162, 263

Issue/Questions: Whether, at the time they become fixed and determinable, contingent liabilities assumed in connection with a reorganization should be capitalized or whether they may be currently expensed.

Facts: We rely on the facts set out in your memorandum dated May 21, 1999. At issue are contingent liabilities for post-employment benefits, for warranty claims, and for a parts return program. In addition, you indicate that the successor corporation (the taxpayer) also deducted costs associated with the environmental clean-up of company-owned stores. The treatment of the environmental clean-up costs is also at issue.

Response: To the extent it is determined that the liabilities in question were assumed in connection with the transfer of assets to the successor corporation in a failed reorganization under section 351, we agree with your conclusion that payments, or accrued expenses attributable to the liabilities should be considered capital expenditures, which become part of the cost basis of the acquired property. David R. Webb Co. v. Commissioner, 77 T.C. 1134, 1137 (1981), aff'd, 708 F.2d 1254 (7th Cir. 1983).

However, to fit within this line of authority, the taxpayer must be paying an assumed obligation of its predecessor, rather than an obligation that arises after the acquisition. This was the distinction the Tax Court underlined in its opinion in M. Buten & Sons, Inc. v. Commissioner, T.C. Memo. 1972-44. In Buten, the successor corporation was obligated to pay the widows of key employees under two agreements. The obligation to pay Fannie Buten arose out of an agreement that the predecessor partnership entered into. The obligation to pay Esther Levin arose out of an agreement the successor corporation entered into just after it was formed. The determination of how to treat the payments rested, in large part, on the distinction between the two agreements. Expenditures resulting from the preexisting agreement under which the payments to Fannie Buten were made were considered part of the acquisition cost of the predecessor partnership. On the other hand, expenditures resulting from the second agreement under which Esther Levin was paid were not and, so, were determined to be currently deductible under section 404.

The same analysis applies to the instant case. To the extent the liabilities arose prior to the reorganization and were assumed by the successor corporation, payments of the liabilities should be treated as capital expenditures. This may be true for payments which do not begin until after the reorganization as long as the liability existed before the reorganization was complete. However, to the extent a determination is made that certain liabilities arise after the reorganization, i.e. that certain liabilities are in fact the taxpayer's rather than the predecessor's, related payments or expenses may be deductible currently, depending on whether they otherwise qualify for current deduction. With respect to the liabilities for post-retirement benefits in particular, the determination of whether the liabilities were preexisting will depend on the terms of the agreements providing for the benefits.

With respect to whether the method of acquiring the partnership's assets affected the result, we referred the matter to the Corporate Branch. The Corporate Branch agrees with your conclusion that in this case it does not affect the result. However, for your information, we bring three revenue rulings that deal with the assumption of liabilities in successful exchanges under section 351 to your attention: Rev. Rul. 95-74, 1995-2 C.B. 36; Rev. Rul. 83-155, 1983-2 C.B. 38; and Rev. Rul. 80-198, 1980-1 C.B. 113. These rulings indicate that, despite the case law to the contrary, in a successful exchange under section 351, the successor entity will be allowed to currently deduct payments which would have been allowed as current deductions had they been made by the predecessor entity. If the court should find that your taxpayer's reorganization qualified under section 351, the rulings would be applicable in your case.

With respect to the costs of environmental clean-up, we have not been provided sufficient information to assess your conclusion that these costs should be treated as capital expenditures. We do not know the nature of these costs and are unable to tell whether they stem from liabilities assumed by the successor corporation as a result of the reorganization. However, we agree that, to the extent the environmental clean-up costs are determined to arise out of assumed liabilities of the predecessor corporation,

the analysis should be the same as with the other assumed liabilities. For general information on the treatment of environmental clean-up costs, you may wish to consider the following revenue rulings: Rev. Rul 1998-25, 1998-19 I.R.B. 4; Rev. Rul. 95-74, 1995-2 C.B. 36; and Rev. Rul. 94-38, 1994-1 C.B. 35. In addition, the treatment of such costs is analyzed in Dominion Resources, Inc. v. United States, 1999 U.S. Dist. LEXIS 2876, (E.D. Va. Mar. 5, 1999); 99-1 USTC (CCH) ¶50,369, and in PLR 9541005, 1995 PRL LEXIS 1265 (Sept. 27, 1995).

Further Action Needed:
Describe:

Yes [] No [X]

Call Returned By: Susan T. Mosley
Date Call Returned: ~~06/04/99~~ 06/07/99
Reviewed By: Thomas D. Moffitt
Office: CC:DOM: FS: IT&A
Date:

Symbols: CC:DOM:FS:IT&A
Time Spent: 2 hours

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